

THIS AMENDMENT:

_____ Passed _____ Passed as amended by _____

_____ Failed _____ Not Offered _____ Withdrawn

GLEASON PROPOSED AMENDMENT # 2

DATE PREPARED: December 14, 2004

COMPANY: UniSource Energy Corporation

DOCKET NO. E-04230A-03-0933

OPEN MEETING DATE: December 20, 2004

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ANALYSIS AND RESOLUTION

Page 29, line 10, DELETE “, as far as we can tell, as case of first impression in Arizona”. INSERT “a case of great significance to Arizona”

Page 31, DELETE lines 5-28.

DELETE page 32-36.

Page 37, DELETE lines 1-7 and line 28. INSERT:

“While that history has been well-documented in numerous ACC proceedings and decisions, certain events are particularly relevant to this proceeding. In January 1994, in Decision No. 58497, the Commission approved an increase in TEP’s operating revenues of approximately \$21.6 million. At the time, TEP’s capital structure was completely debt financed. However, the Commission determined that it was in the public interest to utilize a hypothetical capital structure comprised of 44 percent equity for rate making purposes. In TEP’s subsequent rate case, its financial condition had improved sufficiently to allow the Commission to utilize a hypothetical capital structure for rate making purposes that consisted of 37.5 percent equity. See Decision No. 59594 (March 26, 1996). TEP’s rates have been based on a hypothetical capital structure, consisting of more equity than the company actually had, since the early 1990s. The hypothetical capital structure allowed TEP to collect sufficient revenues from ratepayers to recover from the brink of bankruptcy, and the resulting rates were determined to be just and reasonable in light of the circumstances. Given this historical perspective, it would be in the public interest if the proposed transaction does, as the Applicant claims, address and resolve significant financial issues remaining from those historical events.

We find based on all the evidence, that the proposed reorganization is in the public interest.

The most significant immediate benefit of the reorganization is the improvement to TEP's capital structure and the expected improved access to credit markets. TEP ratepayers have been paying rates based on an hypothetical capital structure that contained more equity than the Company actually had, for many years. See Decisions Nos. 58497 (44 percent equity) and 59594 (37.5 percent equity). During that time the Commission has on several occasions underscored its expectation that TEP will work to improve its capital structure to a point that a hypothetical capital structure is no longer merited. The evidence presented in this case establishes that as a result of the Merger, TEP's actual debt/equity ratio will improve to 60/40 immediately. While this will not have an immediate impact on rates customers pay, the rates established in future rate cases will be based on the actual capital structure of a significantly more healthy utility. In addition, the Company testified that as a result of the reorganization, it has received financing on better terms than it otherwise would, and that it is expected to continue to receive more favorable terms following the Merger based on the Investors' access to capital and TEP's improved capital structure. RUCO has argued that the marginal benefit of the access to capital markets occasioned by the involvement of the Investors does not compensate for the added risks of the reorganization, noting that TEP's debt/equity ratio has been steadily improving and would probably reach the 60/40 debt/equity level in the next three to seven years. (RUCO-1 at 9) However, that position is based on assumptions that may not hold in today's volatile energy industry. There is no guarantee TEP will reach a 60/40 debt/equity ratio in the future. The Merger will ensure that TEP's common equity ratio will increase to 40 percent, thereby ensuring TEP will have immediate improved access and flexibility with respect to financing, and providing its customers the assurance of a healthy utility. Moreover, TEP has committed to make at least \$500 million of voluntary debt and lease prepayments and buybacks prior to December 31, 2008 and, in connection with the Merger, has obtained a new favorable credit facility. This Commission cannot ignore the benefit such improvements will have not only on TEP and its customers, but on the State of Arizona as well. We are aware that the financial markets present numerous investment opportunities for a finite pool of capital, and that denying this transaction may send adverse signals to those markets. We believe approval of the Merger with appropriate protective conditions will encourage continued and increased investment in Arizona.

Over and above the improved financial strength of its utilities, we believe UniSource's commitment to fund \$10 million for Commission approved uses, such as new programs for demand side management, weatherization, and low income assistance and to fund, in excess of its levels of historical giving, \$2.5 million in cash expenditures for charitable and community corporate giving programs between 2005 and 2008 provides an immediate benefit to UniSource customers and is in the public interest.

We believe that Approval of the Merger is in the interest of ratepayers and is in the public interest because of the Conditions that UniSource and TEP headquarters will remain in Tucson, UNS Gas and UNS Electric will maintain their offices in Flagstaff and

Kingman, respectively and that the current senior management will stay in place. We recognize the benefits to the local communities flowing from a local management team and corporate presence, and while there is no immediate indication that the management team would leave or the headquarters would be moved absent the Merger, we view those Conditions as a demonstration of the continued and enforceable commitment by the Applicant to run its utilities locally, and to be responsive to community concerns. The Commission received voluminous comments from charities and municipalities attesting to UniSource's generous funding and good corporate citizenship. The Company has been a generous supporter of communities and charities even while it has been rebuilding its financial health, and we commend the UniSource companies and their employees for their efforts. We are confident and expect that UniSource and its subsidiaries will continue to demonstrate community involvement.

We further believe that the Applicant's agreement to Staff's proposed Conditions regarding the funding of a Commission sponsored management and operations audit, maintenance of accounting and business management records in current forms and TEP's prepayment of debt and lease obligations is in the public interest. While it has been argued that utilities already have an obligation to provide reasonable and adequate service, and to make the expenditures required to do so, history is unfortunately replete with examples of utilities that have not done so. These Conditions provide assurances that the Applicant and the Investors are committed to the responsibility of maintaining the utility systems.

One concern expressed about the proposed transaction is the limited partnership structure. The Commission has the constitutional and statutory authority to examine, inspect and investigate the books and records of public service corporations. Certain parties to the proceeding have argued the limited partnership structure is not as conducive to the disclosure of information as a publicly traded corporate structure. As a publicly traded corporation, UniSource is currently subject to broad disclosure requirements. Certain parties are concerned that the limited partnership structure will weaken and make more difficult the Commission's ability to exercise oversight over UniSource and its subsidiaries. As has been demonstrated historically, and recognized in the enactment of our Affiliated Interest Rules, the activities of non-utility affiliates can have a grave impact on the public service corporations. As part of the Conditions to the Merger, Saguaro LP, Saguaro Holdings and UniSource have committed to provide full access to their records on the same basis as provided by UniSource and its utility subsidiaries. We believe this Condition is essential, in order to enable the Commission to retain the same level of oversight that currently exists, and is a necessary and critical component of the Commission's constitutional duty to protect the interests of both the Company and its ratepayers.

Certain parties to the proceeding have also raised a concern that corporate governance would be weaker under the proposed restructuring than under the current structure. However, in its Exceptions, UniSource agreed to larger Boards of Directors. As a result, these entities will commit to have more, and a greater variety of directors, as shown above.

While a reduction in the number of board members could potentially reduce the breadth of opinions and experience that will formulate corporate policy, it is not breadth of opinions and experience of a board which results in sound policy setting, but the capability and the commitment of the board members regardless of the size. And while we acknowledge that in the absence of the Merger, UniSource can reduce the size of its utility subsidiary boards without Commission approval, we believe given the concentration of ownership inherent in the limited partnership structure, it is appropriate to set minimum board sizes and independence criteria for the utility boards. The Applicant's commitments in this regard, combined with the duties of directors, will ensure the continuity of responsible corporate stewardship at the utility director level.

In Mr. Antonuk's testimony, he states the terms of the limited partnership agreement give the limited partners significant control over details of the Company's operations. (S-3 at 75-88 confidential) In its Exceptions, the Applicant notes that any rights the limited partners have with respect to the Company's operations arise from the consent rights set forth in the Limited Partnership Agreement. The Applicant indicated that those consent rights, as modified, relate to extraordinary events that could alter the nature of their investment. Further, at numerous times throughout these proceedings, the Investors stated on the record their intent to defer to Mr. Pignatelli and his management team on the day-to-day operations of the Company. We believe that the limitation of the consent rights to extraordinary events, together with the protective Conditions agreed to by the Applicant and the continuing authority of the Commission to review whether the actions taken by the utilities are prudent, sufficiently address concerns about control residing with the limited partners. Staff's proposed Condition No. 13, agreed to by UniSource, addresses the issue of changes in control of the limited partners.

Staff believed that at a minimum, to approve the Merger, the Commission must require that UniSource have lenders agree to insert language in their credit facilities that provides all Saguaro Holding and UniSource debt will include separateness covenants. Staff believes that this condition is critical, and recommends that if the Company is unable to negotiate such changes that the Commission should only waive the requirement if ratepayers receive a comparable benefit for the increased risk. We believe the Condition agreed to by the Applicant and the fact that Applicant has obtained the consent of its current lenders to the language satisfying this condition sufficiently addresses those concerns.

For the reasons set forth above, on balance, we believe the proposed transaction is in the public interest and should be approved. Our conclusion is supported independently under our constitutional obligation to act in the public interest as well as pursuant to the provisions of Rule 803(C), as we do not find that the reorganization would impair the financial status of the public utilities or their ability to provide safe, reasonable and adequate service."

Make all conforming changes.